Deficit Elimination, Economic Performance and Social Progress in Canada in the 1990s

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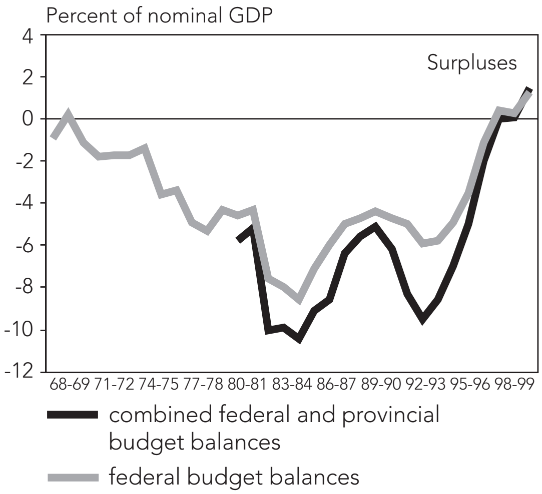
There are at least two broad issues that must be addressed before the story of deficit elimination in Canada and the impact on economic performance and social progress can be told. First, where to start the story, and second, how to define social progress.

One could begin the story in the 1960s, the last time Canadian governments ran balanced budgets. After that, there was a fairly steady fiscal deterioration through the 1970s and 1980s and into the 1990s. The combined federal-provincial deficit did decline from 10.4 percent of GDP in 1984-85 to 5.1 percent in 1989-90 (unless otherwise indicated, all data are on a public accounts basis), but virtually all of this improvement came from economic growth with only a negligible role from policy tightening over the five years. The combined federal-provincial deficit hit 9.5 percent of GDP in 1992-93 and the combined debt-to-GDP ratio peaked at 98.7 percent in 1995-96. This was followed by a very sharp correction, which saw the combined deficit eliminated by 1997-98 and the debt-to-GDP ratio start to decline. Over this 30-year period, many critical things could be said about fiscal management and its impact on economic performance and social progress. The entire period was characterized by lower-than-average growth than in preceding periods, two deep recessions with a very slow recovery the second time, high unemployment on average and periods such as the late 1980s when fiscal policy was working at a cross purpose to monetary policy. One will not find evidence, in this period, that running large deficits and letting the debt burden soar led to good economic performance.

Alternatively, the story could start from the early 1990s. In this case, one would simply accept the starting point of huge deficits and a very high debt-to-GDP ratio. The question then becomes: Was it wise to take bold actions to eliminate this deficit and reverse the deterioration in the debt burden? Even here, the earlier history cannot be forgotten. It would not be a reasonable test to ask whether the process of deficit elimination improved economic performance. Surely some cost, perhaps only of a transitional nature, was to be expected after such a long period of poor fiscal management. The relevant standard should

CHART 1
Canadian Federal and Provincial Government Budget Balances



Source: Fiscal Reference Tables, September 2000, Finance Canada, TD Economics.

be whether the cost to economic performance outweighed the advantages of correcting many of the problems that built up over more than two decades. It is this latter approach that this article takes. In fact, the starting point chosen for the story is the 1993-94 fiscal year. Although this was the peak for neither the deficit nor the debt burden, it is the year prior to that in which the first serious attempts were made by either the federal or provincial governments to tighten fiscal policy.

The second tricky issue is what is meant by social progress. That is addressed in a separate article in this volume. That article does not advance any particular quantitative measures as being useful. For the most part, this article will address questions of economic performance although some general references will be made to social indicators.

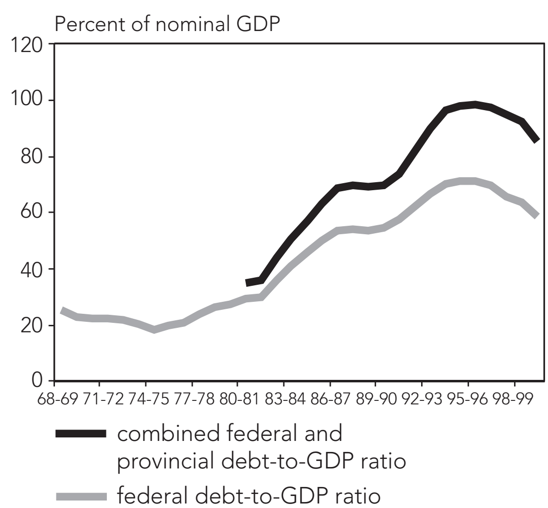
This article will first describe the extent of fiscal tightening after 1993-94. Then it will turn to the impact on economic performance. Finally, some comments will be made on social progress.

MEASURING THE EXTENT OF FISCAL TIGHTENING

The combined federal-provincial (public accounts) budget balance went from a deficit of 8.6 percent of GDP in 1993-94 to a balance by 1997-98. That represents an average annual improvement of 2.15 percent of GDP. Seventy-two percent of the improvement came at the federal level.

In order to analyse the impact of deficit elimination on economic performance, we must identify how much of the improvement came from discretionary policy changes. A standard way of doing this is to look at the changes in cyclically adjusted budget balances (calendar year, national accounts data). This measure removes any changes to budget balances that resulted from the economy

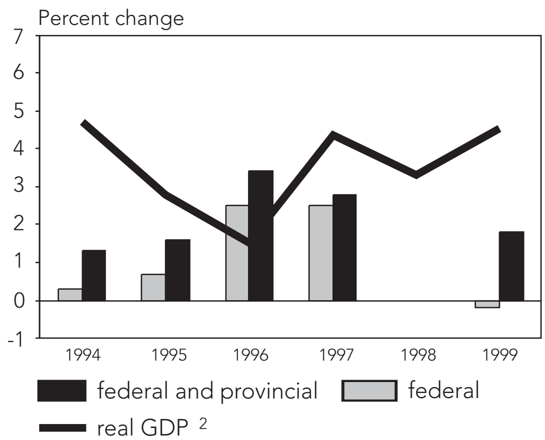
CHART 2
Canadian Federal and Provincial Net Public Debt



Source: Fiscal Reference Tables, September 2000, Finance Canada, TD Economics.

growing either more slowly or more rapidly than at some longer-run "normal" pace. As such, it isolates the discretionary policy changes. Chart 3 plots the changes estimated by Finance Canada in the cyclically adjusted budget balances at the federal and total government sector. According to these estimates, at both the federal and total government levels, 87 percent of the fiscal turnaround from 1993 to 1997 can be thought of as stemming from discretionary policy changes. This result is somewhat sensitive to the methodology and a variety of assumptions, although the estimates of the OECD (*OECD Economic Surveys: Canada,* August 2000) indicate that the portion attributable to policy change is just slightly less. OECD data also indicate that the discretionary policy tightening in Canada was among the most pronounced episodes over a four-year period in any OECD country.

CHART 3
Changes in Cyclically Adjusted Budget Balances[1]



[1] National Accounts balances as a percentage of GDP at factor cost.

[2] Real gross domestic product in 1992 dollars.

Source: Fiscal Reference Tables, September 2000, Finance Canada, TD Economics.

TABLE 1
Federal and Provincial Government Budget Balances
(Share of nominal GDP)

	Federal	Federal & Provincial	Provincial
1993-94	-5.8	-2.8	-8.6
1997-98	0.4	-0.4	0.0
Total Change	6.2	2.4	8.6
Average Annual Change	1.6	0.6	2.2

Source: Fiscal Reference Tables, September 2000, Finance Canada, TD Economics.

A second methodology would be to compile the estimates of discretionary policy change provided in each budget document. There is a fair bit of arbitrariness to this, however. For example, growth in various department spending profiles can be changed quite radically over time without this being described in a budget document as a discretionary change.

Another approach is to analyse the changes in the major budget components with respect to GDP. This is done in Table 2 for the federal government. In order to measure the impact of discretionary fiscal tightening, a "policy-neutral" case must first be defined. In the case of revenues, this is defined as a constant revenue-to-GDP ratio. Implicit in this definition is the notion that if the government were not trying to reduce the deficit, it would introduce tax adjustments to neutralize the tendency of the revenue-to-GDP ratio to rise over time. This tendency is caused by the interaction of economic growth with a non-indexed tax system. For expenditures, some define a policy-neutral case as program spending maintaining its share of GDP. This implies a

TABLE 2
Changes in Federal Government Operating Balance
(Share of nominal GDP)

	1993-94 Adj.	1997-98 Adj.	1997-98 "Neutral Projection"	Diff. between 97-98 Actual and "Neutral Projection"
Revenues	16.4 [1]	17.4	16.4	1.0
Program Spending	16.6	11.8 [2]	15.1	-3.3
Operating Balance	-0.2	5.6	1.3	4.3

[1] Increased 0.4 percentage points to remove the effect of an extra Canada Child Tax Benefit payment (negative revenue) and the accelerated timing of personal income tax refunds that year.

[2] Lowered 0.6 percentage points to remove the effect of one-time bookings for the Canada Millennium Scholarship Foundation, Hepatitis C compensation, the aboriginal healing strategy and changes in accounting for International Financial Institutions.

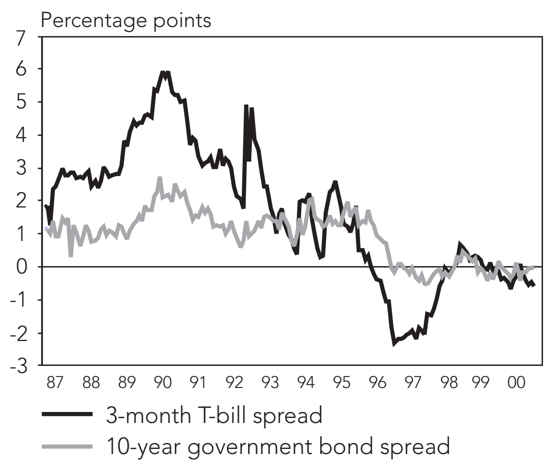
Source: Department of Finance, TD Economics.

steady enrichment of public goods and services over time. Instead, the policy-neutral case is defined here as spen ding growing with inflation and population — in other words, constant in real per capita terms. Over the 1993 to 1997 period, this means total nominal spending growth averaging 2.5 percent per year. Finally, a few adjustments are made to the actual data to remove special entries largely related to accounting (see the footnote to Table 2). Public debt charges are left out of this analysis because there were no direct policy changes which lowered these payments. In fact, the lengthening of the terms of maturity during a period of a positively sloped yield curve raised the cost of debt financing.

Had the federal revenue-to-GDP ratio remained flat from 1993-94 and program spending been allowed to grow with population and inflation, there would have been an improvement in the federal operating balance (revenues less program spending) of 1.5 percentage points of GDP. After adjustments for various accounting changes, the actual improvement was 5.8 percentage points. So this analysis indicates that about three quarters of the actual federal fiscal improvement stemmed from discretionary policy tightening.

Upon looking at two sources of cyclically adjusted budget balances and the above simple analysis of ratios to GDP, the conclusion that the bulk of the actual fiscal improvement was due to discretionary policy tightening seems very robust. The corollary to this statement is that little fiscal improvement would have been realized through 1997-98 if governments had not taken deliberate action. In other words, in the counterfactual world of no discretionary policy tightening, if economic performance had remained as actually recorded, there would have been very little progress

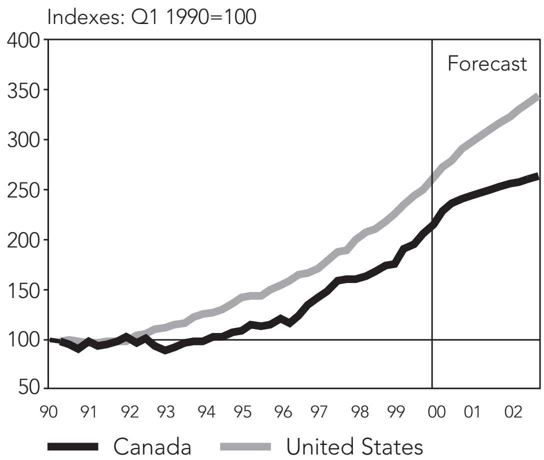
CHART 4
Canada-US Interest Rate Differentials



Note: Last month plotted: October 2000.

Source: Bank of Canada, DRI Canada, TD Economics.

CHART 5
Real Business Investment
in Machinery and Equipment



Note: Forecast by TD Economics as at September 2000; Actual data to Q2-2000 for Canada and Q3-2000 for U.S.

Source: Statistics Canada, U.S. Department of Commerce, TD Economics.

made in lowering deficits and the debt-to-GDP ratio would likely have continued to rise.

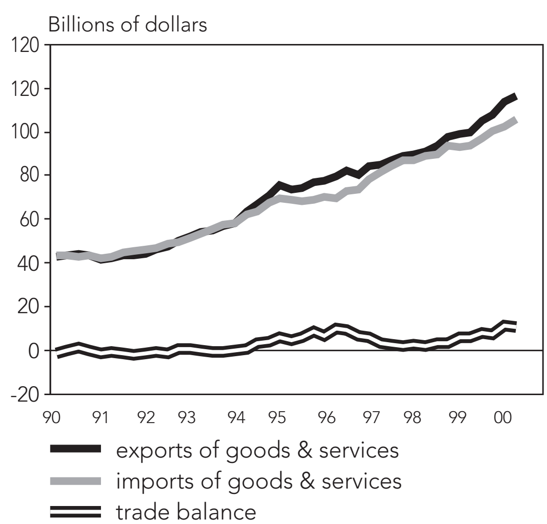
As federal budget surpluses were recorded just four years after serious efforts were begun to eliminate the deficit, it is often suggested that the optimal fiscal policy course would have been a more gradual tightening. With the benefit of hindsight, this at least appears to be a point worth debating. However, the odds were stacked against such an option in 1993 and 1994. Several prior tepid attempts to tighten fiscal policy had not achieved lasting success. In fact, they probably left a net cost due to the loss of policy confidence. Another couple of years of high deficits and a rising debt-to-GDP ratio following 1993-94 may well have contributed further to this loss of confidence. In turn, this could have caused economic performance to worsen.

Another counterfactual case often put forward is that fiscal policy would have needed less tightening if monetary policy had been looser. The conduct of monetary policy in the 1990s is addressed elsewhere in this volume. As monetary policy is managed independently by the Bank of Canada, it is taken as a given for the purpose of this article. It must be pointed out, however, that while the policy authorities are separated, the policies are not. Poor fiscal performance was one of the factors keeping interest rates up in Canada. It is to this, and the link from fiscal policy to other economic indicators, that we now turn.

ECONOMIC PERFORMANCE DURING THE PROCESS OF DEFICIT ELIMINATION

We now need to estimate, or at least make inferences about, the impact of the discretionary policy tightening on economic performance. Ideally we need to infer what

CHART 6
Canadian Trade Balance



Note: Last quarter plotted: Q2-2000.

Source: Statistics Canada, TD Economics.

economic performance would have been in the absence of the policy tightening. Of course we don't have a neat, controlled experiment to do this, although we do have a long sample period when rising deficits and debt burdens were associated with sub-par economic performance. We could assume that changes in the cyclically adjusted budget balances have a one-for-one impact on economic output. This would amount to assuming a fiscal multiplier of one. However, there is no sound basis upon which to make this assumption. Various econometric models could be used to estimate the multiplier, but the results would be very sensitive to model specification and assumptions. This article will take a more descriptive and hence subjective approach.

First, let us look at recent economic performance six years after the intensive efforts at deficit elimination began. The economy grew very steadily through the end of 2000. By virtually any estimate of potential output, the economy was very near to closing or had finally closed the output gap that opened in the early 1990s, the unemployment rate was close to a 25-year low, inflation was low, interest rates were below US levels, investment was booming and we had a record current account surplus. In short, there was not much wrong with this picture. So if there has been an economic cost to deficit elimination, it must have been transitional.

The effects on policy flexibility have already become abundantly clear as well. The federal government and most provincial governments have the luxury of choosing how to allocate surplus funds to tax relief, higher program spending or faster debt retirement. The lower public debt burden helps foster the capital formation needed in this economic environment of rapidly changing technologies.

Let us now look at the shorter run to see how the economy absorbed what amounted to a 9 percent of GDP swing in the total government cyclically adjusted budget balance from 1993 to 1997. Real GDP grew 4.7 percent in 1994 before two shaky years of 2.8 and 1.5 percent and then rebounded to 4.4 percent in 1997, for a four-year average of 3.4 percent. While the economy could have performed better given the large output gap, growth at around the potential pace wasn't bad considering the extent of fiscal tightening.

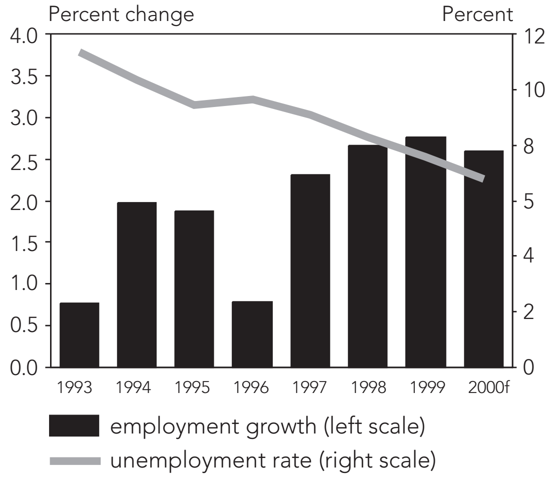
The components of growth provide clear evidence of a classic case of fiscal "crowding in." That is, the private sector stepped up to replace the demand withdrawal from fiscal retrenchment. First, for the first time in decades Canadian interest rates fell below their US counterparts. This occurred first for short-term maturities and then for longer-term issues as the yield curve flattened. In fact, by late 2000 segments of the yield curve were negatively sloped despite a robust economy. The maintenance of low inflation is a factor, but no doubt improved fiscal performance in the United States and Canada has played a role. The Bank of Canada has acknowledged on many occasions how helpful the fiscal tightening was to efforts to get Canadian interest rates down. For example, in a speech to the Canadian Society of New York, on 9 March 2000, Governor Thiessen said, "As progress was made in restoring fiscal credibility, the Bank of Canada was able to lower its policy rate during 1996-97, to levels well below the comparable US Federal Reserve rate. Both market interest rates and the exchange rate moved down in response, helping to stimulate foreign and domestic demand and so moderate the effects of fiscal restraint on economic activity" (p. 3). Second, after lagging badly behind the United States since the beginning of the 1990s, investment started to revive, particularly in machinery and equipment. This offered the hope of Canada soon enjoying the kinds of productivity growth the United States has been experiencing for several years. Third, the Canadian trade balance improved enormously, with the strong growth in the US economy helping quite a bit of course.

So economic performance was pretty good during the years of deficit elimination and got even better once the deficits were gone. We will of course never know what the performance would have been had serious steps not been taken to tighten fiscal policy. But as the deficit would have remained large with a rising debt-to-GDP ratio, it can be argued that we would not have got interest rates down as much and business and consumer confidence would not have strengthened to the same extent. At best the Canadian economy would have returned to its potential level of output somewhat earlier. Even this is not clear. What is clear is that the fiscal situation would have remained problematic.

THE NATURE OF THE FISCAL TIGHTENING AND SOCIAL PROGRESS

There is a debate over how far strong job creation can go in addressing issues of "social progress." However, one thing is certain. It can't hurt. Chart 7 shows that

CHART 7
Canadian Labour Market Performance

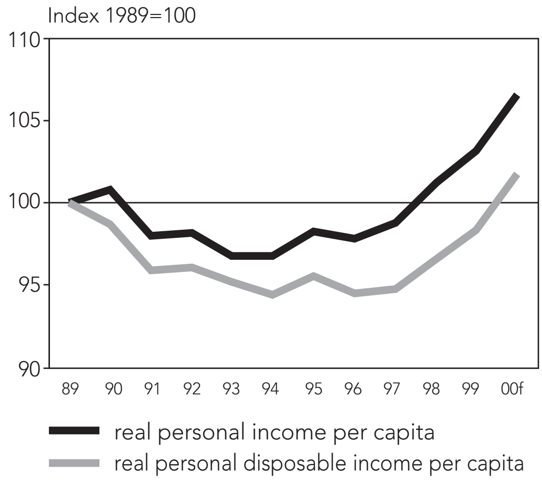


[f] forecast by TD Economics as at October 2000.
Source: Statistics Canada, TD Economics.

employment grew throughout the period of deficit elimination and the unemployment rate fell steadily. Employment did not expand rapidly enough, however, to raise real personal income per capita, and on an after-tax basis this measure of income continued to fall until 1997. However, both measures have now recovered to the peak levels of the beginning of the 1990s, and with employment and wages continuing to rise, while taxes are being cut, disposable incomes should continue to grow.

Throughout the 1990s the distribution of income moved away from the lower end towards the higher end. However, this likely had much more to do with changes in the economy and in particular the rising education and skill requirements for new jobs and the strength in the stock market than with fiscal policy. Even to the degree fiscal policy had a role, it would be difficult to say that the process of deficit elimination was the root problem. The deficit could have been elimi-

CHART 8
Canadian Living Standards



[f] forecast by TD Economics as at October 2000.
Source: Statistics Canada, TD Economics.

nated in a variety of ways, each having differing impacts upon income distribution. That is the question we now turn to.

So far, deficit elimination has been analysed from an aggregate or macroeconomic perspective. But can it be argued that the fiscal tightening hurt economic performance and social progress because of the particular manner in which it was done? It would be hard to make this case on the revenue side. There were very few revenue-raising actions taken over the period of deficit elimination. In fact, the only rate increase was for the excise tax on gasoline. There was some base broadening, but this largely affected corporations and higher-income individuals, not the usual fodder for criticisms on social progress. So if there is a negative case, it must rest on the program spending side.

For the federal government, aggregate program spending in nominal dollars was reduced from $120.0 billion in 1993-94 to a low of $104.8 billion in 1996-97, before rising to $108.8 billion in 1997-98 and then $111.8 billion in 1999-2000. If we take out the $5.5 billion of one-time entries in 1997-98, program spending would have stayed down at $103.3 billion that year. In contrast, if program spending had grown with population and inflation since 1993-94, it would have stood at $132.6 billion in 1997-98. So without a doubt the cuts to spending were substantial. Of course, some of this was due to economic growth. For example, of the $16.7 billion decline in spending from 1993-94 to 1997-98 (after removing the $5.5 billion of one-time entries), $5.8 billion came from lower Employment Insurance benefits and, in turn, about one half of that decline came from lower unemployment. Even the roughly $3 billion of benefit tightening from discretionary policy change should not be interpreted as being a pure drag on economic performance. The tightening was designed to improve the incentives to work and in particular to shift from seasonal to more year-round employment.

Table 3 shows the changes in program spending from 1993-94 to 1997-98 by major component. Old age security payments were not subject to restraint and hence grew with the relevant population and inflation. EI benefits were discussed above. Transfers to provinces fell $6.4 billion. Beginning in the 1980s, various measures were introduced to curtail the growth of transfers to the provinces. In particular, as of 1990 the Canada Assistance Plan payments to the non-equalization-receiving provinces were restrained. Effective in 1996-97 the transfers were consolidated into the Canada Health and Social Transfer. This ended any statutory cost-sharing between the two levels of government. The CHST is notionally for health, post-secondary education and social programs. However, it is a block fund and can be used in any fashion the provinces wish. That being said, there is no doubt that cuts to these transfers were a catalyst for a good part of the restraint exercised by the provinces in health care, post-secondary education and welfare. To the degree that fiscal restraint led to some needed financial reforms in the health-care sector, there is one offsetting benefit. However, there can be no denying that health care, post-secondary education and welfare are areas where deficit elimination hurt and hence a case can be made that these cuts impeded social, and economic, progress for a time. It should be noted that the cash transfers to the provinces under these programs will soon be restored to the previous peak levels and will grow with an escalator. As well, it should be noted that the federal government has contributed in these areas in other ways, such as directly funding university-based research through the endowment of the Canada Foundation for Innovation, and supporting students through enhanced tax measures and the Canada Millennium Scholarships. The federally funded Canada Child Tax Benefit will soon reach $7 billion on an annual basis whereas the former Family Allowances never exceeded $2.8 billion. The increased federal support has not only boosted incomes for families with children but has allowed the provinces to divert their funding away from income support to in-kind services to ensure that people do not lose benefits when they become employed.

After removing the $5.5 billion of one-time entries, subsidies and other transfers fell $1.5 billion. Within this category, there was a large shift away from business subsidies, which were cut 70 percent under Program Review, towards support programs, such as

TABLE 3
Federal Government Program Spending
(Billions of dollars)

	1993-94	1997-98	Change
Total Program Spending	120.0	108.8	-11.2
Old Age Security	19.9	22.2	+2.3
Employment Insurance Benefits	17.6	11.8	-5.8
EPF/CHST	16.8	10.5	-6.3
Fiscal transfers (incl. equalization)	10.1	10.0	-0.1
Other transfers and subsidies[1]	18.5	22.5	+4.0
Crown corporations[2]	5.3	2.5	-2.8
National Defence	11.3	8.9	-2.4
Other departments and agencies	20.5	20.3	-0.2

[1] The 1997-98 figures include $5.5 billion of one-time entries which would not be expected to have an economic effect in that year. Excl. these entries, other transfers and subsidies fell $1.5 billion.
[2] Only $0.6 billion of the decline from 1993-94 to 1997-98 relates to cuts from program review. For 1993-94, large entries were recorded to cover prior-year losses whereas by 1997-98, many crown corporations were making a profit.

Source: Fiscal Reference Tables, September 2000, Finance Canada, TD Economics.

those for aboriginals, which continued to grow rapidly throughout the period. Expenditures relating to Crown corporations went down substantially, but only $0.6 billion of that relates to cuts under Program Review. The rest stems from large provisions recorded in 1993-94 to capture prior-year losses, whereas by 1997-98 many of the corporations were making a profit. National Defence spending was pared down substantially and the total of all other operating expenditures hardly changed at all despite the population growth and inflation over the four years.

This review of program spending indicates that efforts were made to preserve spending in a number of areas typically thought to relate to social progress. In some areas where the cuts were quite deep, such as health care, funding has largely been restored. There is no doubt that if one were to go a layer further in the program detail, one would find many examples of deep cuts, or outright elimination of programs related to social policy. But it is important to recognize that one of the reasons why the federal government's deficit-elimination effort was broadly accepted, indeed encouraged, by Canadians is that it was seen as broad. It can be argued that more selectivity in the cuts would have risked undermining that support and hence made the effort much more difficult politically to accomplish.

CONCLUSION

All in all, one would have to say that the experience of deficit elimination worked out very well, likely better than almost any observer in the early 1990s, including governments, would have thought. The economy has performed well in terms of output and employment growth and the unemployment rate has come down sharply. Not only is the deficit eliminated at the federal and total government sector level, but the debt burden is down sharply. This presents much more choice going forward than could have been dreamed of a few years ago. As just one example, instead of 36 cents of every federal revenue dollar going to debt payments, it is now 25 cents. That is still way too high, but it frees up 11 cents on the revenue dollar for lower taxes, higher program spending or faster progress on debt retirement. The lower public debt burden as well as the shift in government spending from a consumption-base (such as subsidies) to an investment base (such as research) will foster the capital formation the economy needs to raise its potential output growth rate.

It would be foolish to argue that there was no pain from the experience. After all, what could be expected after the depth of the fiscal mess by 1993-94? Some of the signs of that pain are apparent on the program side, such as problems in the health-care sector and underfunded post-secondary education. On the economic front, changes in the economy skewed the income distribution more to the higher end and governments may not have been as free to support those with lower incomes had they not been in deficit-elimination mode. However, at the very worst, the charge against deficit elimination is that there was some short-term pain to secure substantial long-term gain.